2
The Choice of Rationales and the Social Meaning of Derivative Actions

2.1 Introduction

This chapter aims to analyse the theoretical rationales behind derivative actions, and to ask how they relate to our understanding of the social value and roles of the derivative action as a corporate governance tool.¹

The discussion is organized as follows. An initial analysis of the merits and demerits of the derivative action is presented in section 2.2. Section 2.3 analyses the roles derivative actions may assume in enforcing corporate accountability. The question addressed is whether their purpose is primarily to deter misconduct or simply to compensate the company for the wrongdoing. As part of this, the possible benefits and limitations of these rationales will be explored. Finally, section 2.4 examines the public image, or expressive value, of the derivative action. The purpose is to determine if some of the features inherent in the derivative action procedure enhance or detract from the understanding of derivative action as a positive social force.

A final word before we proceed. Some of the themes in sections 2.3 and 2.4 are drawn from derivative actions theory found in American literature. The writer believes it is imperative to pay attention to American developments as well as developments in other jurisdictions. The derivative action in the US has become a very sophisticated procedure and there is a rich and vast literature on the subject. However, a note of caution must be sounded when making direct comparisons with shareholders’ litigation in the US. The derivative action in the US is a sophisticated mechanism with several distinctive features. The differences can be explained in terms of the impact of existing legal rules, policy issues and reliance on alternative enforcement mechanisms. That said, the US legal system has nevertheless had to address somewhat similar problems (for example, the floodgates argument) and has had to resort to various restrictive rules, some of which have similar theoretical suppositions to the English common law; thus ratification will sometimes

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shut down a derivative action. Other rules are technical bars designed to discourage derivative actions, such as the requirement for a minority derivative litigant to give security. The focus here is on theoretical issues, and there is no reason to assume that the same incentive structures do not present themselves in the UK, although the same level of activity is not present. The analysis in this chapter focuses principally on Delaware as the paradigm.² The aim is twofold: (1) to indicate, in the light of research from the US, where the discussion in the UK should be conducted, and (2) to examine what can be learnt from the experience in the US. The theoretical foundations outlined in this chapter will then be analysed to develop the conceptual framework in which derivative actions in English law may be accommodated.³

2.2 Merits and Demerits of Derivative Actions

In the previous chapter we saw that shareholder litigation is neither the initial nor the primary protection for shareholders against managerial misconduct. A variety of social and market forces as well as professional agents of the board and the shareholders (so-called ‘gatekeepers’) and market forces also operate to hold corporate officials accountable. Yet no single technique of accountability is likely to be optimal under all circumstances. Each has its characteristic and well-known limitations. As a result, shareholders are best served by an overlapping system of protections, one of which is by means of derivative actions. At the same time, it should not be assumed that derivative actions are an unqualified good. There are valid reasons why *litigation* would leave the company worse off than before. In a nutshell, the common, partly overlapping, objections include the following:⁴

(1) There is the danger that a company will be burdened with an action that it does not want. As Templeman LJ stated in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*,⁵ the company in that case might have felt that ‘it might be killed by kindness’. For example, while winning the legal arguments and obtaining an enforceable remedy, the company may suffer

² See further RJ Gilson ‘Globalizing Corporate Governance: Convergence of Form or Function’ (2001) 49 American Journal of Comparative Law 329, 350 (‘The aggregated choices of a majority of publicly traded U.S. corporations have resulted in a convergence on the Delaware General Corporation Law as a de facto national corporate law’). Indeed, more than half a million business entities have their legal home in Delaware including more than 50% of all US publicly traded companies and 58% of the Fortune 500. See <http://governor.delaware.gov/news/2005/03march/031005%20-%20delaware's%20legal%20system.shtml>.

³ See Ch 5 below, where we assess whether, as a matter of policy, there is any viable role for derivative action in English law in light of the rationales identified here.

⁴ Some of the issues raised below are not exclusive to derivative actions, but have a more general application to claims by companies against wrongdoing managers. On the problems presented by the uneasy position of shareholders in derivative action, see Ch 3 below under 3.2.2.

⁵ [1982] 1 Ch 204, 221.
collateral harm which outweighs the gain from litigation. This may include
also non-monetary harm, ie litigation may produce unwanted publicity,
which in turn may affect the long-term reputation of the company, which
will deter further investment. Overall then, litigation may simply not be
worth the expense.⁶

(2) There may be doubts about whether a verdict in favour of the company will
be obtained, either because of disputes about the law or because of difficulties
proving the events said to constitute a breach of duty. In addition, the
defendants may not be in a position to meet the judgment even if litigation is
successful.⁷

(3) There are also hidden costs beyond the direct costs of litigation.⁸ Litigation
can disrupt the decision-making process and thereby impose unforeseen and
undetected costs. For example, management must take time away from daily
business operations to prepare for the action. That time costs the company
not only in salaries, but also in lost revenues because (a) management is often
too busy to oversee operations as effectively as in the absence of litigation;
and (b) the impact of distraction of key personnel by continued litigation.
Litigation may therefore consume an undue amount of management time,
and the senior management time spent on litigation might be more profiably
be used elsewhere (ie seeking appropriate opportunities for investments).
There will therefore be cases where a company’s interests will be best served
by foregoing litigation in favour of alternative courses of action (for example,
relying on the threat to terminate relations with an employee to force a
settlement).⁹

(4) Derivative actions generate agency costs of their own. For example, the
increased risk of litigation might deter individuals from becoming directors.¹⁰
Accordingly, the use of derivative actions can raise the expenses that companies
must incur in order to attract managers. In theory, a manager’s net return from
his job must equal some ‘reservation’ level for him to be willing to work for the
company.¹¹ Hence, if managers face a risk of action, a company must either

BR Cheffins ‘Reforming the Derivative Action: The Canadian Experience and British Prospects’
[1997] 2 CFILR 227, 230; PL Davies Gower and Davies’ Principles of Modern Company Law (7th edn
Sweet & Maxwell 2003) 443 (hereafter ‘Gower and Davies’).
⁷ Gower and Davies ibid.
⁸ Joy v North 692 F 2d 880, 892 (2d Cir 1982); P Banta ‘Note: The New Indiana Business Corporation
⁹ BR Cheffins, above n 6, 230.
¹⁰ This relates to a wider issue, namely the problem of fixing the appropriate level of performance
required by directors in discharging their duties. Arguably, the preferred strategy should not be to
institute a mechanism that prevents wrongs from being remedied. See further R Kraakman PL Davies
¹¹ This is the net return that the manager could obtain from the best alternative place of employment.
supply them with adequate liability insurance\textsuperscript{12} or raise their salaries\textsuperscript{13} by an offsetting amount to induce them to maintain their position.\textsuperscript{14}

(5) Litigation agency costs may also arise in other forms. As we saw, a derivative action is a legal oddity. A self-appointed shareholder (and that litigant’s attorneys) champions the claims on behalf of the company. The small actual return to any one shareholder means that the incentives of the protagonist claimant may diverge from those of the company as a whole. This, in turn, may result in incurring further agency costs. Because of his small stake in the company, the complaining shareholder has very little incentive to consider the effect of the action on the company as a whole.\textsuperscript{15} Thus derivative actions create a risk of strategic behaviour by minorities. One salient example is the possibility for ‘gold-digging’ claims against the company which are settled on terms advantageous to the claimant shareholder and the defendants but which do not reflect the appropriate value of the company’s right for relief or are not in the interests of the company.\textsuperscript{16}

(6) A common argument made opposing derivative action is that it deters legitimate risk-taking on part of managers. Imposing liability may discourage entrepreneurial risk-taking and adversely affect profit maximization. Fear of liability makes directors more risk averse. Arguably, this is possibly the greatest cost of derivative action litigation.\textsuperscript{17} Those hired to run corporations are hired to take calculated risks in pursuit of profits. Since shareholders are protected from risk volatility by diversified portfolios, in the long run they gain from management taking a risk.\textsuperscript{18} Directors, on the other hand, are not well situated to absorb losses from decisions that turn out unprofitably.\textsuperscript{19}

\textsuperscript{12} See in this context CA 1985, s 310 (replaced by CA 2006, ss 532–533) discussed in Ch 5 below under 5.4.2.5.

\textsuperscript{13} Some express doubts that salaries will arise to compensate managers for corrupt gains that they are denied by the threat of suit. For the grounds for such scepticism, see R Kraakman H Park and S Shavell ‘When Are Shareholders Suits in Shareholder Interests?’ (1994) 82 Georgetown Law Journal 1733, 1738 and 1748.

\textsuperscript{14} The action, even if ultimately won by defendants, may be seen by board members not only as taking time, but also putting them in the uncomfortable position of having to submit to questions testing their ability to remember past events accurately and articulate answers with clarity. There is also the risk of generating unfavourable publicity which harms the directors’ reputation. See RH Mundheim ‘Commentary: The Social Meaning of Shareholder Suits’ (1999) 65 Brooklyn Law Review 55, 56–7.

\textsuperscript{15} More on this important point in Ch 3 below under 3.2.2.1.

\textsuperscript{16} In order to reduce the possibilities for ‘gold-digging’ settlements are controlled by the court. See below under 2.4.4.

\textsuperscript{17} P Banta, above n 8, 236.

\textsuperscript{18} Because potential profit often corresponds to the potential risk, it is arguably very much in the interest of shareholders that the law does not create an incentive for overly cautious corporate decisions. Some opportunities offer great profits as the risk of very substantial losses, while the alternatives offer less risk of loss but also less potential profit. \textit{Jay v North} 692 F 2d 880, 886 (2d Cir 1982).

\textsuperscript{19} Coffee, for example, argues that directors are ‘poor cost avoiders’ with respect to corporate losses flowing from negligent decision-making and hence can be rendered excessively risk averse.
First, business decisions rarely involve black-and-white issues; instead, they typically involve prudential judgments among a number of plausible alternatives. Given the vagaries of business, moreover, even carefully made choices among such alternatives may turn out badly. Secondly, directors at most serve only a handful of firms, and if they are personally liable for some portion of the losses their only option is to avoid the risks, and such aversion to risk hurts shareholders.

Arguably, after-the-fact litigation is an imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur’s function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.

Immeasurable costs are incurred because of the oppressive effect litigation has on morale. This may result in the departure of key personnel. Even in the absence of an action or the immediate threat of one, a general fear of litigation can cause boards to incur costs that would not otherwise be necessary. Directors’ concern about possible legal liability for decisions serves only to reduce risk-taking and the attractiveness of board positions, while only adding expensive paper trails. In order to avoid liability, directors will keep longer paper trails and hire more experts than they need to make decisions, and probably more than the law requires. In the absence of certainty, too much is safer than too little.

It is clear then that there are valid reasons why litigation would leave the company worse off than before. The litigation decision involves a commercial judgment based on an assessment of the arguments for and against the initiation of litigation (risks, expenses, and possible benefits) and may be regarded as an ‘investment decision’ for the company. Overall, then, the decision not to sue a director will not always be an easy one and a negative decision is not necessarily a sign that the company is being too lax towards its directors. On the other hand, whatever the nature of a derivative claim, it is generally thought that the action may entail possible benefits in several ways. These benefits are usefully summarized below in Table 2-1. More specifically, Table 2-1 sets out four roles—two as in instrument in corporate governance and two more ‘traditional’

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21 P Banta, above n 8, 237.
22 Joy v North 692 F 2d 880, 886 (2d Cir 1982).
23 P Banta, above n 8, 237.
24 Gower and Davies, above n 6, 443.
in nature—that, taken together, span the derivative action’s principal objectives. These four roles clearly overlap. The purpose of Table 2-1 is simply to emphasize the various ways in which derivative actions can be used as well as to contrast the possible roles in corporate governance with the more ‘traditional’ ones. As such, Table 2-1 does not offer a new formalistic schema that displaces rather than aids functional understanding.

Consider first the left-hand side of the table (the two columns in grey) where we find the two main purposes that the derivative action is usually said to serve in corporate governance, namely deterrence and compensation. The argument that the primary role of shareholder derivative actions is the reduction of agency costs assumes that such actions deter mismanagement. The assumption is that liability rules enforced by derivative actions play a fundamental role in aligning the interests of managers and shareholders.²⁵ In addition, most analyses assume as well that the purpose of the action is simply to compensate the company and its shareholders for the harm caused. In the following section we closely examine these rationales.

The purpose of the bottom row in Table 2-1 is to highlight the fact that three of the possible roles of derivative action take full effect ex post, that is only after the action is brought. For instance, the financial benefit of compensation (ie recovery), by its very nature, can only be realized after the derivative action is brought. By contrast, deterrence works both ex ante and ex post. As will be seen below, deterrence involves both ex ante expectations of wrongdoers (regarding the probability and the magnitude of the threat of expected liability should they decide to engage in wrongdoing) as well as actual ex post liability for the total harm they cause.²⁶


²⁶ See 2.3.3.1 below.

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Table 2-1. Roles of derivative actions

<table>
<thead>
<tr>
<th>Role</th>
<th>Deterrence</th>
<th>Compensation</th>
<th>Filling gaps (ancillary role)</th>
<th>Enforcement of directors’ duties (traditional view)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Possible benefits</td>
<td>Deterrence of unwanted managerial behaviour</td>
<td>Recovery*</td>
<td>Fills gaps in incomplete contracts between shareholders and managers</td>
<td>Holding directors accountable</td>
</tr>
<tr>
<td>Takes effect</td>
<td>Ex ante</td>
<td>Ex post</td>
<td>Ex post</td>
<td>Ex post</td>
</tr>
</tbody>
</table>

* As is explained below under 2.3.2.2, this includes both recovery in the sense of financial recovery and the return of the company’s property.
Consider now the right-hand side of Table 2-1 (the two columns in white) where we find the two other purposes that the derivative action is traditionally said to serve. First on the right-hand side, we find the traditional view of derivative actions, namely enforcement of directors’ duties. As will be seen in Chapter 3, a corollary objective of derivative actions is to ensure that directors pay heed to their legal duties. Although directors’ duties are owed formally to the company and not to individual shareholders, it is essentially shareholders’ interests that are protected by the imposition of these duties.²⁷ The imposition of duties sets limits to the directors’ exercise of corporate powers and attempts to control the exercise of managerial discretion and self-interested behaviour. The effectiveness of such duties and controls depends on there being realistic enforcement, or at least the prospect thereof. But, as will be seen in Chapter 3, there are difficulties with this because, circuitously, the directors owe these duties to the company and the company’s decision to call the directors to account is made for it by the board. For these reasons, duty-based controls therefore depend very much on viable shareholder enforcement.²⁸

A fourth role should be mentioned briefly: the gap-filling role (second column from the right—in white). An additional potential social benefit from derivative action litigation is ancillary to its role as a governance device: legal rules are public goods.²⁹ In theory, litigation can reduce legal uncertainty. The absence of clear legal rules is costly.³⁰ For one thing, it leads to variance in assessments of the legal standard

²⁷ The main fiduciary duty owed by directors is the duty to act bona fide in the interests of the company and these interests have time and again been equated with the interests of the shareholders as a whole. See, for example, Allen v Gold Reefs of West Africa Ltd (1900) 1 Ch 671. But see now CA 2006, s 172, which enshrines in statute the principle of ‘enlightened shareholder value’ and requires a director to act in the way he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole and, in so doing, have regard to the factors listed. This list is not exhaustive, but highlights areas of particular importance which reflect wider expectations of responsible business behaviour, such as the likely consequences of any decision in the long term (s 172 (1) (a)); the interests of the company’s employees (s 172 (1) (b)); the need to foster the company’s business relationships with suppliers, customers, and others (s 172 (1) (c)); and the impact of the company’s operations on the community and the environment (s 172 (1) (d)). Section 170(1) makes it clear that the duty is owed by a director to the company. So it follows that only the company can enforce it. This might necessitate transcending existing organizational culture and shareholder expectations. However, it is noteworthy that in response to debates in the House of Lords as well as detailed engagement with interested parties the Government made amendments to the language of s 172 (1) late in the day, which it hoped would put beyond doubt that the need to have regard to certain factors (including the interest of the employees and impact on the environment) is subject to the overriding duty to act in the way the director considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.

²⁸ See further Ch 3 below under 3.2.1.


and thus to divergences of behaviour from the social optimum. Some corporate fiduciaries may overestimate the legal constraints and forego efficient transactions, while others may underestimate the very same constraints and carry out inefficient transactions. Further, legal indeterminacy creates liability risk, which risk-averse fiduciaries are in a poor position to bear. Exposing corporate fiduciaries to this risk makes their services more costly and less productive to shareholders.

It is generally thought that much of the company’s contract is informal and confused. The complete contingent claims contract, which seeks to predetermine all the future behaviour of the company and the substantive rights and duties of corporate actors, is particularly impossible and financially undesirable. Gaps are inevitably left in the company’s contract. The long-term nature of the contract and its consequential incompleteness entail an unusually high degree of legislative and judicial intervention. Beyond mere gap-filling, the informational problems enjoyed by shareholders inherent in the long-term corporate relationship demand and justify some judicial control of the parties’ express bargain. One mechanism for filling these gaps is through judicial construction. The judiciary may be involved in a process of ex post construction of the company’s contract.

For example, contractual gaps may be addressed by duties imposed by the courts. By virtue of case law precedents a director must act with care, skill, and diligence, must act in the best interests of the company, must not put himself in a position where his personal interest conflicts with the company’s, and must account for any personal profits made while acting on behalf of the company. As decided cases accumulate, the interpretation and proper application of fiduciary standards, for example, become clearer, allowing directors and officers to estimate legal outcomes more accurately and thus to behave more closely to the social optimum. All companies benefit from a judicial decision clarifying the scope of permissible conduct. The benefit of clarification is not simply deterrence of future managerial conduct, but rather, given the contractual setting of the

References:


32 CA Riley ‘Contracting Out of Company Law: Section 459 of the Companies Act 1985 and the Role of the Courts’ (1992) 55 MLR 782. Indeed, as Coffee has pointed out, the protection of minority shareholders is required, as private bargaining may be unable to prevent opportunistic taking advantage of minority shareholders (JC Coffee ‘The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role’ (1989) 89 Columbia Law Review 1618) and upholding of fairness for minority shareholders would be essential for facilitating investment and it is in both the interests of public policy and the corporation to do so. Thus, minority shareholder protection would be more likely regarded as a prohibitive rather than a facilitative or merely default regime: IH Chiu ‘Contextualising Shareholders’ Disputes—A Way to Reconceptualise Minority Shareholder Remedies’ [2006] JBL 312.

33 CA Riley, above n 32.


35 Ibid. See generally, Gower and Davies, above n 6, Ch 16.

36 E Kamar, above n 30, 890.
company, identification of a rule around which the parties, namely managers and shareholders, can transact.³⁷ It may well be that the law in this area is fostering efficient outcomes by playing a ‘gap-filling’ role.³⁸

The scenario described so far has, nonetheless, a serious limitation in practice. It presupposes a rich seam of modern judicial precedent on which to build this gap-filling role. But it has been correctly observed that the UK does not have nor, despite recent reforms to the derivative action, is it likely in future to have a large number of actions producing a rich seam of modern judicial precedent on which to draw in order to remove uncertainty about precisely what is required of directors in particular circumstances.³⁹ This may suggest then that this role may have somewhat limited scope in the UK.

2.3 The Choice of Rationales: Deterrence versus Compensation

2.3.1 The primary purposes of derivative actions in the US

Arguably, any legal rule that imposes duties on potential wrongdoers and delivers compensation to injured victims would seem to have the features of general deterrence, particular compensation and consequential social benefits as presented above. The question is then which of these purposes of the derivative action is, or should be, the primary justification?

The argument that the primary role of shareholder derivative actions is the reduction of agency costs assumes that such actions deter mismanagement. If a net economic benefit to the company were a prerequisite to derivative proceedings, fraud which did not exceed a certain level would never be pursued.⁴⁰ The assumption is that liability rules enforced by derivative actions play a fundamental role in aligning the interests of managers and investors. In this respect, it is thought that derivative action has a prophylactic effect which is salutary.⁴¹ In addition, most analyses assume as well that the purpose of the action is simply to compensate the

³⁷ R Romano above n 29, 83.
³⁸ BR Cheffins, above n 34, 134.
³⁹ E Ferran ‘Company Law Reform in the UK’ (2001) 5 Singapore Journal of International and Comparative Law 516; JC Coffee ‘Privatization and Corporate Governance: The Lessons from Securities Market Failure’ (1999) 25 Journal of Corporation Law 1 (noting the sharp contrast between the UK and US in shareholder enforcement). The 2005 White Paper acknowledged that it is unlikely that putting derivative actions on a statutory footing will affect the low number of cases brought (White Paper Company Law Reform (Cm 6456) (DTI March 2005) Annex A, 277), and this view was again and again expressed by the Government’s representatives and reports during the discussions on the statutory derivative action under Pt 11 of CA 2006 (see Ch 4 below under 4.4).
⁴¹ See also Consultancy Report, Review of the Hong Kong Companies Ordinance (March 1997) 149, 152.
company and its shareholders for the harm caused. Of course, either deterrence or compensation can be taken to extremes.⁴²

It could be argued that neither mission conflicts with the other, since to hold a person accountable to those harmed by his misdeeds provides a powerful disincentive for others to conduct themselves similarly.⁴³ Circumstances might arise, nonetheless, where the costs to the company of continuing litigation are likely to equal or exceed the expected recovery.⁴⁴ If the basic rationale were compensation, there would seem little justification for permitting such an action to continue in the company’s name. Conversely, from a deterrence perspective, if the underlying conduct involved illegal, fraudulent, or predatory behaviour, the long-term ‘generic’ collective interests of shareholders might well justify the continuation of such an action.⁴⁵ A basic tension then exists between these two rationales and no facile answer is offered in this chapter to reconcile them.⁴⁶

It is interesting to note that the American Law Institute (‘ALI’) looked to balance the competing rationales⁴⁷ and, while recognizing the need for compensation, also suggested that there is ‘generic benefit’ to the shareholder who holds a portfolio of shares in that there is enhanced deterrence against wrongdoing even though the costs in a specific action may exceed the return to the company.⁴⁸ ALI suggests that the termination of an action on the grounds that it does not produce a net benefit would ultimately increase average agency costs.⁴⁹ The commentary accompanying the ALI’s proposals justifies the use of the derivative action even if no gain accrues to a specific company on the grounds of the social benefits⁵⁰ that flow from deterrence as well as the enforcement of regulatory provisions.⁵¹ Overall, then, the ALI philosophy is that deterrence predominate when a compensatory purpose is lacking.⁵² In Australia, on the other hand, the Corporate Law Economic Reform Program Proposals for Reform Paper states that ‘the statutory action is

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⁴⁵ See below under 2.3.3.1.

⁴⁶ For a careful consideration of how the distinction between instances in which an enhanced sanction designed to deter might best be imposed in contrast to the more frequent instances in which a compensatory sanction will fulfill desirable deterrence objectives, see RD Cooter ‘Punitive Damages, Social Norms, and Economic Analysis’ (1997) 60 Law & Contemporary Problems 73.


⁴⁸ ibid 601.

⁴⁹ ibid.

⁵⁰ On the social benefits see below under 2.4.


not intended to be regulatory in nature but to facilitate private parties to enforce existing rights attaching to the company, although some commentators believe the statutory derivative action in Australia serves both purposes. In other words, in giving shareholders an effective means of enforcing their rights and recovering money owed to the company, the goal of deterrence is achieved.

Two questions arise in response: (1) which view has the stronger foundations? and (2) what are the reasons put forward for each of these views? In order to answer these questions, it is useful to examine now the benefits and limitations of these two rationales. Table 2-2 below summarizes the major points.

### 2.3.2 Compensation

#### 2.3.2.1 The rationale and decision rule

Let us begin by looking at the left-hand side of Table 2-2. There are those who would restrict the derivative action to a compensatory function. Proponents of a compensatory derivative action consider that, if a cost-benefit analysis concludes that the damages suffered by the company could not be rectified in money or money’s worth, then the interests of the company and the shareholders are better served if leave to bring proceedings is refused. If compensation is to be the fundamental justification for the action then a simple decision rule should exist for when the action should be allowed to proceed: does the expected recovery exceed the expected litigation costs that the company will bear (including the plaintiff’s attorney fees)?

#### 2.3.2.2 Limitations

A compensatory rationale brings to the fore various difficulties. As can be seen in the fourth row of Table 2-2, a compensatory rationale has at least five

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53 Corporate Law Economic Reform Program (CLERP) Proposals for Reform Directors’ Duties and Corporate Governance (Paper No 3 1997) 35. A similar view was expressed by the judiciary: ‘The action for relief... under the statutory derivative action [is a remedy] to vindicate an interest of the company as a whole, with consequent benefit to all current shareholders or members’ (Westgold Resources NL v Precious Metals Australia Ltd [2002] WASC 221, [21] per Heenan J).

54 Kaplan and Elwood, for example, believe that ‘it seeks to provide some level of deterrence against abuses of managerial or directorial authority, and it provides an avenue whereby, through shareholder activism in the absence of action by the board of directors, the corporation can recover damages or property belonging to the corporation’. W Kaplan and B Elwood ‘The Derivative Action: A Shareholder’s “Bleak House”?’ (2003) 36 University of British Columbia Law Review 443, 455. This view is supported by I Ramsay and B Saunders ‘Litigation by Shareholders and Directors: An Empirical Study of the Statutory Derivative Action’ (2006) 6 JCLS 397, 410.

55 I Ramsay and B Saunders, above n 54.


critical shortcomings. First, the change in composition of shareholders means that shareholders at the time of injury who subsequently dispose of their shares prior to a court order for recovery do not obtain compensation, while incoming shareholders receive a windfall gain.⁵⁸ When the recovery is on behalf of a publicly traded company this necessarily enriches any shareholder who became such after the action was commenced. In the public company, share ownership changes daily so that those who own their shares when the impacts of the defendant’s wrongdoing occurred will not be the same owners when damages are recovered.


Table 2-2. Deterrence versus compensation—benefits and limitations

<table>
<thead>
<tr>
<th>Compensation</th>
<th>Deterrence</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Rationale</strong></td>
<td>The action may confer <em>monetary benefits</em>, as companies may recover damages from wrongdoing directors</td>
</tr>
<tr>
<td><strong>Decision rule</strong></td>
<td>‘<em>Generic benefit</em>’ to the shareholder who holds a portfolio of shares: enhanced deterrence against wrongdoing</td>
</tr>
<tr>
<td>(ie on what basis should the action be allowed to proceed)</td>
<td>Does the expected recovery exceed the expected litigation costs that the company will bear?</td>
</tr>
<tr>
<td><strong>Sanctions</strong></td>
<td>In the absence of recovery, would the public benefits outweigh its private benefits?</td>
</tr>
<tr>
<td><strong>Recovery</strong></td>
<td>Mainly intangible <em>non-monetary sanctions</em></td>
</tr>
<tr>
<td>(ie financial penalties and the return of the company’s property)</td>
<td></td>
</tr>
<tr>
<td><strong>Limitations</strong></td>
<td></td>
</tr>
<tr>
<td>● Change in composition of shareholders</td>
<td>● Its level is very difficult to estimate⁶</td>
</tr>
<tr>
<td>● Injury to the company is not the same as the injury suffered by shareholders</td>
<td>● Paradox of timing of the action—ex post⁶</td>
</tr>
<tr>
<td>● The wealth effects of derivative actions are negligible</td>
<td>● May impose costs well in excess of the original injury</td>
</tr>
<tr>
<td>● Non-tangible relief</td>
<td>● May not always impose an adequate sanction</td>
</tr>
<tr>
<td>● More easily and less wastefully achieved through means other than litigation</td>
<td>● Requires shareholders’ commitment to a policy of action</td>
</tr>
<tr>
<td><strong>Possible value</strong></td>
<td>Arguably high</td>
</tr>
</tbody>
</table>

#Footnotes#
- See discussion above under 2.3.3.1.
- See discussion above under 2.3.3.1.
Arguably, the post-wrongdoing set of shareholders is not unjustly enriched because theoretically a portion of their purchase price reflected the expected value of the derivative action being brought on behalf of their company. Nevertheless, it is difficult to see how the post-wrongdoing set of shareholders has been injured by the defendant’s wrongdoing; they are instead recovering on a purchased chose in action.⁵⁹

Secondly, the injury to the company resulting from, for instance, a breach of directors’ duties is not necessarily the same as the injury suffered by shareholders.⁶⁰ For example, even if an efficient securities market translates an injury suffered by the company into a decline in share value, it may be that the loss of the shareholders will exceed that of the company because the events will be perceived by the marketplace as creating a risk of repetition.⁶¹

Thirdly, various empirical studies in the US have concluded that in the typical derivative action, while the total amount of recovery may be significant, it is generally de minimis on a per share basis.⁶² Put differently, these studies point out that the wealth effects of derivative actions are negligible.⁶³ Accordingly, if all the derivative action accomplishes is the refund of a few cents per share to thousands of individual shareholders, the argument goes, it is difficult to conclude that such a result justifies the considerable drain on judicial time and court resources that the litigation of this complex form of action creates.⁶⁴ Although this fact causes little difficulty from the standpoint of deterrence, it is difficult to justify the costs imposed by such litigation on the company and the judicial system as a whole if the primary goal is compensation.⁶⁵

Fourthly, a related problem is strongly reinforced by real-world observations: not all derivative actions lead to a tangible relief.⁶⁶ It is not unusual, for example,

⁵⁹ J Cox, above n 52.
⁶⁰ J Coffee and D Schwartz, above n 42, 304. This point is also essentially recognized by the Consultation Paper para 16.4 and is linked to the so-called ‘reflective loss rule’ on which see Ch 7 below under 7.2.2.3.
⁶¹ J Coffee and D Schwartz, above n 42, 304.
⁶³ The real problem with any study finding a negligible benefit is that it cannot measure the deterrent or compensatory capacity of the derivative action in the abstract but only under a specific set of legal rules. Unfortunately, no parallel empirical research exists on the wealth effects of derivative actions in the UK (possibly as the data is so scarce). Ultimately, empirical research cannot prove that the derivative action can or cannot work. See further JC Coffee, above n 56, 1436–7. Further, the same critique could be made of criminal law. The fines imposed by a criminal court often may fall bellow the state’s cost of prosecution. Nonetheless, criminal prosecutions continue, either because society believes in a general deterrence or because it enjoys retribution.
⁶⁴ JC Coffee and D Schwartz, above n 42, 304.
⁶⁶ This, in turn, raises another problem. When derivative litigation results in an intangible or therapeutic relief only (even if shareholder litigation results in deterrence benefits), there should be little reason for individual shareholders to sue. See Ch 6 below under 6.2.2.
that the remedy is proprietary, where, for example, the directors’ conduct involves misappropriating the company’s assets.  

These four problems—the constant changes in the composition of shareholders, the fact that the injury to the company is not the same as the injury suffered by shareholders, the *de minimis* recovery on a per share basis, and the non-tangible relief—are emphasized here not to challenge the desirability of securing full compensation for wrongs done to the company, but rather to indicate that a compensatory rationale cannot fully justify the derivative action or, indeed, explain the high costs incurred in the process of litigation, as discussed in section 2.2 above.  

Still a fifth and more theoretical objection to the use of a compensatory rationale as a leading principle is simply that compensation might be more easily and less wastefully achieved through means other than litigation. A variety of insurance systems could in principle be authorized to protect shareholders from the risk that their company would be injured because of self-dealing or other abuses. More simply, shareholders, can, and to some large extent do, protect themselves from such risks through portfolio diversification in order that their single company exposure to loss is small. Yet such insurance systems for shareholders would not seem to satisfy the community’s desire to punish wilful abuses on the part of those who undertook to serve it (ie the community), and indeed, unless subject to limitation, they might even give rise to the moral hazard of encouraging abuses.  

2.3.3 Deterrence

2.3.3.1 The rationale and decision rule

In the previous section we saw that compensation has some serious limitations. While these limitations do not imply that compensation is an illusory goal altogether, they do indicate that a compensatory rationale cannot fully justify

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67 In which case a tracing order against and a charge over the misappropriated assets will be most suitable. See, for example, *Clark v Cutland* [2003] EWCA Civ 810; [2004] 1 WLR 783 (an unfair prejudice petition, in which the Court of Appeal had held that it was able to make the type of order that it could make in a derivative action and grant a tracing order, as there was a derivative action in the background with which the petition had been consolidated). For liability to account for property that had been misappropriated, see generally *Cook v Deeks* [1916] 1 AC 554 (PC); *Daniels v Daniels* [1978] Ch 406.

68 J Coffee and D Schwartz, above n 42, 305. Support for this view can be found in landmark cases such as *Diamond v Oreamuno* 301 NYS 2d 78, 81 (1969); *City of Riverside v Rivera* 106 S Ct 2686 (1986).


70 Arguably, the pricing of insurance premiums would be a more precise internalization mechanism than ad hoc litigation, not least because the insurance company would act as an ongoing monitor for the company’s activities and the scope for misbehaviour by directors.

71 See n 70 above.

72 See further n 70 above.
the derivative action. On this view, the goal of deterrence may be seen as a key element (subject to its own costs as discussed below) in reducing the agency costs inherent in the management of companies.⁷³ As can be seen in the second row of the right-hand side of Table 2-2, if deterrence is to be the fundamental justification for derivative actions, a simple decision rule should exist for when the action should be allowed to proceed: in the absence of recovery, would the public benefits from litigation outweigh its private benefits?

While a simple rule exists to decide when the action should be allowed to proceed, it is virtually impossible to identify a general deterrent effect. This is because the precise effect of deterrence is virtually incalculable or at least not readily quantifiable.⁷⁴ Two major factors combine to create this effect. First, evidence here is virtually non-existent, because general deterrence is not easily or readily susceptible to empirical testing. We cannot estimate the number of offences and thereby estimate the probability of detection, which is essential for measuring such an effect.⁷⁵ For example, it is hard to test empirically because it requires an examination not of the share price of the subject company, but of the share price of all companies affected by the action or companies whose managers believe themselves to be affected.⁷⁶ Secondly, the deterrence factor lies in the subjective, subconscious reactions of directors and thus is almost untraceable.⁷⁷

The difficulty stems also, in part, from the fact that the case for a deterrence rationale rests on an unknown and probably unknowable variable: the gains to shareholders resulting from future misconduct that is deterred.⁷⁸ Although these gains cannot be quantified reliably, it is easy to understate them. In part, this is because a successful derivative action is likely to produce a positive externality: it will deter misconduct in other companies.⁷⁹ As a result, even if the deterrent benefits to the company in whose name the action is brought do not exceed the company’s direct and indirect litigation costs, its shareholders still may benefit.⁸⁰

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⁷³ I Ramsay, above n 58, 156.
⁷⁴ A similar problem exists with director disqualification procedures (see Ch 5 below under 5.4.2.2): since the costs, and to an even greater extent the benefits, are not readily quantifiable, it must remain a matter of speculation whether expanding the scope for director disqualification in the UK has yielded a net social benefit. See BR Cheffins, above n 34, 553.
⁷⁵ R Romano, above n 29, 84–5.
⁷⁸ JC Coffee, above n 56, 1428.
⁷⁹ In this respect, Shavell explains that the social benefits of litigation could exceed the private benefits in some instances. An illustration would be where the action generates some beneficial deterrent effects that cause others to desist from a course of conduct that would impose externalities on society: S Shavell ‘The Social versus the Private Incentive to Bring Suit in a Costly Legal System’ (1982) 11 JLS 333.
⁸⁰ For example, a recent study in the US has shown that the impact of recent decisions in derivative cases (such as Caremark, Disney and Oracle) goes well beyond the outcome of the cases themselves—these decisions changed the rules for future legal practice by forcing companies to
In addition, arguably, a credible threat of an action, particularly one that can get beyond a motion to dismiss, has an important consequence. The desire to avoid actions, and certainly the desire to be able to construct very good defences, provides a lever for influencing the conduct of senior management and the board.\(^{81}\) In addition, when the deterrence question is focused upon a threatened harm to shareholders themselves, there is a basis to permit some recovery out of prophylactic considerations to remind the directors that their ultimate responsibilities are to the shareholders.\(^{82}\)

As can be seen, deterrence operates on two levels—first, the company which is subject to litigation and, secondly, the ‘family of companies’ as a whole. With respect to the latter, because shareholders generally do not own shares in a single company but hold diversified portfolios, they benefit if a derivative action deters potential defendants who are situated similarly at other companies, even if it involves a net loss to the company in whose name the action is brought.\(^{83}\) It is important to understand this, because in some circumstances the benefit of a derivative action may accrue less to the shareholders of the subject company and more to shareholders generally in the form of increased deterrence of managerial abuse. As a result, shareholders as a class could benefit even though a particular company’s share declined because the company was compelled to incur litigation expenses in excess of the specific benefits it received.\(^{84}\)

Why would there be such a benefit? As Coffee usefully explains, the logic is the same as in the case of criminal enforcement. Both the derivative action and criminal enforcement depend on an external enforcer—the public prosecution or the plaintiff shareholder (private enforcer).\(^{85}\) The idea is that the conviction of a company’s director presumably deters not only other officers of the same company but also other directors of other companies.\(^{86}\) One obvious difference between these two enforcement mechanisms is that the criminal law can threaten imprisonment sanctions, while a derivative action can employ only the threats of financial penalties, loss of reputational capital, and social stigma.\(^{87}\) And accept better conduct and procedures. See further R Thompson R Blakey and R Thomas ‘The Public and Private Faces of Derivative Lawsuits’ Vanderbilt Law and Economics Research Paper No 04-14 (2004), available at <http://ssrn.com/abstract=555813>.

\(^{81}\) In other words, education of the board and senior management may well be an ancillary benefit when assessing the impact of these actions. See also RH Mundheim ’Commentary: The Social Meaning of Shareholder Suits’ (1999) 65 Brooklyn Law Review 55, 57.

\(^{82}\) Particularly when the shareholder-focused model of company law currently prevails in English law. See Ch 5 below under 5.4.1.2, and J Cox, above n 52, 764.

\(^{83}\) J Cox, above n 52, 764.

\(^{84}\) JC Coffee, above n 76, 673.

\(^{85}\) JC Coffee, above n 56, 1428–9.

\(^{86}\) Consider, for example, the US case in *Rosenfeld v Black* 445 F 2d 1337 (2d Cir 1971). The case held that an adviser to a mutual fund occupied a fiduciary relationship to it and could not sell that position for a profit. The profit in that situation amounted to pennies per share. But the point here is that the case set a standard of conduct which reverberated throughout the mutual fund industry. The same could be said of many other notable cases. See Ch 5(b) below n 258.

\(^{87}\) JC Coffee, above n 56, 1429.
although these intangible non-monetary sanctions, namely loss of reputation and social stigma, are even harder to estimate, only a fool ignores them.⁸⁸ Another major distinction is that public enforcers are not motivated by the pecuniary profits they may gain from litigation, but rather by policy goals and institutional incentives. Indeed, criminal law enforcement is based almost exclusively on sanctions that do not directly benefit law enforcement authorities. At the same time, when enforcement is entrusted to individual plaintiffs, it is more difficult to combine lenient sanctions with frequent enforcement. Unlike paid prosecutors, private plaintiffs will bring an action only if they expect to collect damages high enough to recover their expenses. The central difficulty then lies in the fact that the amount of damages that optimally deters defendants’ misconduct will not necessarily prompt the proper level of litigation by plaintiffs. A discussion on how to overcome this difficulty is deferred until Chapter 7, when we examine how to design adequate models of funding that would, in turn, induce shareholders to sue in appropriate circumstances.

2.3.3.2 Limitations

If the observations made so far suggest that deterrence should provide the primary rationale for the derivative action, it must be acknowledged, as the fourth row in Table 2-2 indicates, that this rationale is, of course, subject to its own limitations. Let us review these limitations.⁸⁹ First, the derivative action cannot always impose an adequate sanction. Because wrongdoers usually will be asked to make restitution, merely compensatory damages, it is argued, may not invariably amount to an effective sanction.⁹⁰ Secondly, deterrence may have a chilling effect on the willingness of a company’s directors to take risks which is especially troublesome in the case of outside directors whose services may be discouraged. One criticism is that the net result of liability rules enforced by derivative actions may not be that directors are deterred from acting negligently, but only that they are deterred from acting without expensive paper trails and excessive expert advice.⁹¹ While some costs are to be expected, they should be minimized. When the marginal cost of additional liability, including all the costs discussed above, is equal to the agency costs avoided, the system is efficient. Those who reject the deterrence rationale believe that this balance is not achieved. The argument runs along the lines that enforcement of liability rules through derivative litigation is inappropriate, as the

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⁸⁹ In addition to the following three limitations, two other limitations (namely, that the level of deterrence is very difficult to estimate and the paradox of timing of the action) were already discussed above under 2.3.3.1.
⁹¹ P Banta, above n 8, 237.
costs of litigation may impose costs on the company well in excess of the original injury allegedly committed by the directors.⁹²

In short it can be seen that deterrence may have a high cost. This last problem with the deterrence rationale is mitigated to a considerable extent once shareholders are recognized as having a generic interest as a class in an effective system of corporate accountability.⁹³ As explained above, because over the long run the shareholder invests in a portfolio of companies rather than a single security, the shareholder may benefit from enforcement costs in a single case even though these costs may exceed the ultimate recovery to the individual company. In any case, these problems probably affect only a minority of cases and do not imply that the derivative action cannot generally produce the necessary measure of deterrence in other cases.⁹⁴

Crucial to the foregoing discussion is one further difficulty. A shareholder’s interest in bringing the action may diverge from the company’s interest in either direction.⁹⁵ On the one hand, a shareholder may rationally decide not to sue when willingness to do so would raise corporate value. This can occur because, even though action is discouraged by an expected recovery that is small relative to litigation costs, the prospect of action would have served to deter misconduct. On the other hand, a shareholder may elect to bring a derivative action when this will be likely to lower corporate value. The reason, in essence, is that the expected recovery from managers that motivates actions may be only an apparent gain to the company: it will be offset, at least in part, by increases in liability insurance premiums, indemnification payments made by the company on the managers’ behalf, and managerial compensation.⁹⁶ For these reasons, under a broad class of regimes for allocating the costs and benefits of derivative actions (including the English rule which allocates costs to shareholders pro rata), shareholder incentives to sue may be either excessive or insufficient, relative to the criterion of maximizing corporate value.⁹⁷ Although in theory the shareholders’ goal is assumed to be the maximization of corporate value, their incentives whether or not to bring a derivative action may not advance corporate value. As a logical matter, a variety of legal strategies might ameliorate the misalignment of the shareholder incentives to bring action that have been identified here. A discussion of such possible strategies is deferred to Chapter 7.

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⁹² P Banta, above n 8, 236–7. It should be noted that proof of this is as elusive as proving the contrary. See D Fischel and M Bradley ‘The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis’ (1986) 71 Cornell Law Review 261, 292.


⁹⁴ ibid 235–6.


⁹⁶ ibid.

⁹⁷ ibid.
2.3.3.3 How does deterrence operate?

We have yet to deal with a basic and important question: how does deterrence operate? It is the purpose of this section to review this briefly. By way of disclaimer, it should be clarified that the present inquiry concerns itself neither with the level of investment that will be necessary to obtain optimal deterrence, nor with the magnitude of expected liability given any level of investment in a derivative action. Instead, the inquiry that follows is concerned with generating unambiguous statements about classic deterrence theory. These statements will then be analysed in the discussion in Chapter 5.

Classic deterrence theory treats the severity of sanctions and the frequency of enforcement as alternative policy tools for regulating behaviour. Legal sanctions force individuals contemplating undesirable behaviour to weigh their potential liability against their private benefit from that behaviour. They will engage in the controlled activity only to the extent that their private benefit exceeds their expected liability. In principle, numerous combinations of sanctions and enforcement levels can achieve the same deterrent effect. Monetary sanctions, for example, can be as low as a few pence or as high as the entire personal wealth of defendants. The rate of law enforcement can vary from bringing to court a few wrongdoers to bringing to court as many as can be detected.

Deterrence of wrongdoing is ordinarily obtained by imposing on potential wrongdoers a threat of ex post liability for the full cost of harm caused to victims by their wrongdoing. The argument is that the threat of liability for the full cost of harm caused by wrongdoing (ie compensatory damages) is the optimal measure of damages where the wrongdoer is found liable with certainty.


100 A director, having to decide whether to enter a self-dealing transaction, will compare the expected benefits he receives from the transaction with the expected costs imposed on him by the legal system, in the case that judicial intervention is successfully triggered. See further RC Cooter and BJ Freedman 'The Fiduciary Relationship: Its Economic Character and Legal Consequences' (1991) 66 New York University Law Review 1045, 1052.

101 E Kamar, above n 30, 897.

102 The themes in this section are drawn from G Halfteck 'The Effects of Incentives to Invest and the Level of Investment in Class Action Law Enforcement on the Magnitude of Liability for Harm', Discussion Paper No 452 (12/2003), available at <http://www.law.harvard.edu/programs/olin_center/> (hereafter ‘G Halfteck’).

Imposing such a threat leads companies to internalize ex ante the social cost of their contemplated behaviour and make optimal investments as a precaution to reduce the risk of harm. Deterrence, it follows, implicates wrongdoers’ ex ante expectations regarding the probability and the magnitude of the threat of ex post liability (ie expected liability), should they decide to engage in wrongdoing. The magnitude of ex ante expected liability from derivative actions is a function of several independent variables, including (1) the probability of detecting the wrongdoer’s behaviour so as to bring a action on behalf of the company; (2) the probability of holding the wrongdoer liable by obtaining a favourable judgment or a favourable settlement that is approved by the courts; and, finally (3) the magnitude of average damages awarded to the company (whether by means of judgment or a settlement). The exact properties are highly context-specific and are therefore not specifically discernable.

Where liability is a viable possibility regardless of whether the alleged wrongdoer has acted wrongfully, the deterrent effects of such a threat of liability are said to be inefficient because such liability creates an ex ante inducement to invest in precautions even though such investment is not socially efficient. Where the magnitude of expected liability is equal to (or even slightly less than) the full social cost of harm caused by the wrongdoer’s conduct, the wrongdoer is optimally deterred from engaging in a contemplated wrongdoing. Optimal deterrence is therefore obtained where wrongdoers face a threat of ex post liability for the total harm they cause, neither more nor less. In fact, where wrongdoers face a threat of liability that exceeds or falls short of the measure of compensatory damages, potential wrongdoers will be over-deterred and under-deterred, respectively. Competing considerations need to be balanced. On the one hand, the availability of legal recourse is essential if management’s obligations to its shareholders are to constitute more than a precatory body of law. Some judicial mechanism for the enforcement of fiduciary duties must therefore exist that is independent of management’s control. On the other hand, few corporate transactions are not susceptible to differences of opinion. Nor are courts infallible.

are responsible, however, the optimal threat of liability should exceed the social cost of harm generated by their conduct (ie compensatory damages) by an award of punitive damages—such that, on average, they will pay for the harm caused: ibid 873–6, 887–900.

104 G Halfteck, above n 102, 14.
105 ibid 54–5.
106 ibid 13.
107 Attorney’s fees that are incurred by the wrongdoer should also be counted in the cost that is internalized by the wrongdoer, so they can be added to obtain optimal deterrence.
108 G Halfteck, above n 102, 13.
109 Above under 2.2.
What is clear, however, is that those who start from the a priori view that corporate wrongdoing is not sufficiently deterred at present may want to argue for increasing the focus on managerial liability.¹¹⁰ There will be cases, as occur in the US, Canada, and Australia, where derivative action proceedings prove justified as a mode of redressing serious corporate abuse.¹¹¹ Similarly, those that believe corporate behaviour is over-deterred should favour increasing corporate criminal liability to avoid more costly measures.¹¹² Obviously, those whose function is to represent the interests of large public companies, such as the CBI and leading firms of City solicitors, will resist any changes in the law that might encourage an ‘active’ market in civil litigation by minority shareholders.¹¹³ It will be contended that the ‘burden’ of self-regulation, the investigatory powers of the DBERR, and the criminal law are all sufficient to cope with any fraud or mismanagement that may occur in public companies.¹¹⁴ The counter-intuitive nature of many of these conclusions raises interesting questions about whether it makes sense to regulate the business arena, and at what cost, but these are questions beyond the scope of this work.

2.4 Understanding the Social Meaning of Derivative Actions

2.4.1 Introduction

Crucial to the foregoing discussion is one further issue. This section explicates the public image, or expressive value, of the derivative action. The purpose is to determine whether some of the features inherent in the derivative action procedure enhance or detract from derivative action being understood as a positive social force. The premise driving this inquiry is an understanding that the higher the public esteem of the derivative action, the greater will be its deterrent value.¹¹⁵ To illustrate why this premise is correct, consider the following study by social psychologist Robert Cialdini.¹¹⁶

Cialdini placed flyers under the windshield wipers of cars and observed how their drivers disposed of the flyers upon returning to their cars. In the case of one group of drivers, an associate of Cialdini would pass by the driver, pick up some litter, and discard the litter in a refuse container. Very few of the drivers

¹¹⁰ See, for example, A Boyle Minority Shareholders’ Remedies (Cambridge University Press 2002) 13.
¹¹¹ ibid.
¹¹² On the limitations of corporate criminal liability see JE Parkinson, above n 25, 354–61.
¹¹³ A Boyle, above n 110, 13.
¹¹⁴ ibid. It is noteworthy that this argument is more geared towards public companies, leaving out, yet again, the possible benefits of derivative actions in private companies. See Introduction above under 4, Ch 5 below under 5.3.2, 5.4.4.1(a) and (c) and Ch 8 below under 8.2 and 8.3.7.
¹¹⁵ The discussion that follows draws heavily on Cox ‘The Social Meaning’, above n 43.
in this group threw the flyer on the street. In contrast, over one-third of the drivers who did not witness the responsible behaviour of the passer-by discarded the flyer onto the street. The study reflects the well-documented tendency of individuals to make social choices by reference to the conduct of others.¹¹⁷ The relevance of the littering study to the derivative action turns on whether the initiation, maintenance, and dismissal of a derivative action are like the conduct of Cialdini’s responsible associate. Can the action cause corporate managers (Cialdini’s drivers) not involved in the action to conform their future behaviour to the normative standards invoked by the action’s plaintiff (Cialdini’s associates), so that managers will place the shareholders’ and investors’ interests where they should be rather than irresponsibly discarding them?²¹¹⁸

In this section, the question asked is whether the derivative action itself can be viewed as a responsible actor so that, much as in the case of the passer-by, the action’s existence deters misconduct by others. The continued existence of the derivative action is easier to justify if it has such an effect. Simply stated, so far we considered the deterrent value of private litigation in terms of the sanctions it provides. Here a new consideration is added, namely, the social opprobrium that attaches to the action’s defendants as a consequence of being pursued in a derivative action. In this respect, it is vital to consider to what extent certain procedural and substantive features of derivative action contribute positively or negatively to their social meaning.

2.4.2 Construction and deconstruction

Whether and to what extent a derivative action has a reputational impact upon its defendants is proportional to the expressive value enjoyed by all derivative actions. That is, the message of the individual derivative action is affected by the company it keeps with other derivative actions.¹¹⁹ To be sure, the substance of the claim against a manager has much to do with the sting he will feel from the action’s charges. A charge that directors were grossly negligent in approving compensation and perquisites for the company’s senior managers takes on a very different cast when coupled with charges of cronyism or even self-dealing. Even a complaint that a manager failed to disclose adverse confidential information regarding the company takes on quite a different meaning when it is also alleged that he gained privately through insider trading.¹²⁰ Although an action’s substantive charges have a reputational impact that depends on the


¹²⁰ ibid 6.
nature of the complaint, the charges are weakened if the medium through which they are asserted lacks a credible reputation. Charges of usurping corporate opportunities, for example, will fail to convey the social condemnation for such misconduct if the charges are not seen as credible. The derivative action, if commonly understood to be frivolous, will not affirm the social norms the action’s defendants allegedly violated. The defendants will instead be seen as the objects of bad luck, not derision. Thus the procedural context in which corporate norms are developed and affirmed are of the utmost significance if those norms are to discipline managers.¹²¹

The following discussion examines to what extent features of derivative action are consistent with the process of establishing and affirming norms for business organizations. As discussed below, some features of derivative actions are destructive to their role in managing norms for corporate law, whereas other features contribute positively toward that role and in turn enhance the action’s social meaning.¹²²

2.4.2.1 Ambiguity of the action’s objective

We should recall that compensation of the injured and deterrence of misconduct are the joint purposes of derivative actions. However, in the corporate setting, derivative actions are usually perceived as addressing purely private injuries, even though the goal of deterrence might be advanced by the successful prosecution of the action. The resolution of a private dispute appears to be the prevailing objective of a derivative action and deterrence its valuable by-product. Thus the public role of the derivative action is muted and indeed obfuscated by the characterization of its objective as simply doing justice to those harmed by the defendant’s misconduct.¹²³ In the end, derivative actions have only a private existence so that in the public’s eye they are just another commercial dispute.

We arrive now at the thrust of the argument. Arguably, the courts’ preoccupation with the private nature rather than the deterrent aspects of derivative actions leads to ambiguity in the action’s expression of social values. Few shareholder actions entail breaches of a private contract between the claimants and the action’s defendants. Instead, most actions are based on breaches of

¹²¹ ibid. Arguably, in the same fashion, in an environment where the derivative action is seen as an instrument that affirms desirable norms in the corporate setting, one derivative action litigant may persuade other litigants in other companies to litigate.

¹²² Cox explains (above n 43, 8) that the inspiration for organizing the following analysis is Professor Lessig’s insights on techniques for constructing social meaning. Lessig isolated the ways the expressive value of an event, such as the imposition of a sanction, can be influenced. The four ways he poses, and around which the following discussion is organized, are ambiguity, tying, inhibition and ritual: L Lessig ‘The Regulation of Social Meaning’ (1995) 62 University of Chicago Law Review 943, 1009–34.

¹²³ The latter objective is well illustrated in the reasoning of Nurcombe v Nurcombe [1985] 1 WLR 370, 378 per Browne-Wilkinson LJ.
fiduciary obligations or, more specifically, fraud embodied in the common law;\(^{124}\) or now embodied as part of one of the statutory duties under CA 2006, Pt 10. At common law a shareholder can only enforce the company’s claim if the breach of duty was a ‘fraud’ and the wrongdoers were ‘in control’;\(^{125}\) Fraud in this context means ‘fraud in the wider equitable sense of that term’.\(^{126}\) Essentially, the term encompasses situations such as where the majority are endeavouring directly or indirectly to appropriate to themselves money, property or advantages which belong to the company or in which other shareholders are entitled to participate…\(^{127}\). Therefore attempts by the majority to sell worthless assets to the company,\(^{128}\) to divert business from the company to themselves in breach of fiduciary duty\(^{129}\) or to compromise litigation against bodies in which the majority are interested on terms prejudicial to the company\(^{130}\) have all been held to amount to ‘fraud’ in this context, entitling minority shareholders to bring a derivative actions.\(^{131}\) The term has also been applied to the negligent decision of directors, who were also the majority shareholders, to sell company assets to one of their number at an undervalue,\(^{132}\) and to acts of a controlling shareholder which had the effect of stultifying the purpose for which the company was formed.\(^{133}\)

It is clear then that in most derivative actions the norm invoked has a substantial, if not exclusive, public source and importance. Indeed, it has been argued that the right for a minority shareholder to take derivative action performs the purpose of checking majority abuse of the company and is thus a public good provided by regulation which otherwise would not be if left to private bargain.\(^{134}\) Or as an Advisory Committee in Australia put it: ‘private enforcement accomplished

\(^{124}\) Take, for example, \textit{Atwool v Merryweather} (1867) LR 5 Eq 464n. The claimant claimed rescission of a contract entered into by directors and the return of money and shares paid to them in consideration for the sale, claiming that they had made a concealed profit. The court held that the directors had acted fraudulently and upheld the claimant’s claim. Seemingly, the nature of the dispute here is solely private. The nature of offence committed, however, is anything but—finding that directors acted fraudulently may well have public effects such as disqualification in accordance with s 4 of the Company Directors Disqualification Act 1986. This process involves the public imposition of very high level of disapproval by the judicial system. See also BG Pettet \textit{Company Law} (2nd edn Longman 2005) 418.

\(^{125}\) \textit{Prudential Assurance Co Ltd v Newman Industries Ltd} (No 2) [1982] Ch 204, 211.


\(^{127}\) \textit{Burland v Earle} [1902] AC 83, 93 (PC) per Lord Davey.

\(^{128}\) \textit{Atwool v Merryweather} (1867) LR 5 Eq 464n.

\(^{129}\) See, for example, \textit{Cook v Deeks} [1916] 1 AC 554 (PC).

\(^{130}\) \textit{Menier v Hooper’s Telegraph Works} (1874) 9 Ch App 350; \textit{Estmanco (Kilner House) Ltd v Greater London Council} [1982] 1 WLR 2.

\(^{131}\) A purported ratification of wrongful acts might itself, in some circumstances, constitute a fraud on the minority.


\(^{133}\) \textit{Estmanco (Kilner House) Ltd v Greater London Council} [1982] 1 WLR 2.

via shareholder litigation may be preferable to public enforcement.’¹³⁵ As such, this area of law is thus more mandatory/prohibitory in nature and should not be contractually waived or modified.¹³⁶ As will be seen in Chapter 5,¹³⁷ the corporate group, rather than what Wigram V-C described in Foss v Harbottle as the ‘private partnership’, has become ‘the quintessential model of corporate business activity in the late twentieth century’.¹³⁸ In this context, corporate activity (and in particular the exercising of directors’ discretion in business decision-making) has become more of a ‘public’ concern, which should therefore be subject to greater judicial scrutiny in order to protect individual members’ rights.¹³⁹

In theory, therefore, derivative actions provide a public link to the norm by requiring resolution in court, where potentially a public voice, the court, addresses the facts of each case through the lens of the applicable norm. Because ‘fraud’ and ‘control’ are both private matters¹⁴⁰ whereas deterrence is of public concern, the more squarely the courts place the objectives of derivative actions in the private sphere, the weaker the public perception will be that such actions are reflections of society’s condemnation of the misconduct underlying the charges of the action. To the extent that actions are perceived as addressing purely private injuries, instead of being understood to address violations of the public interest in ways that cause private harms, the public perception will be that derivative actions are but a subset of the standard commercial dispute between two warring financial interests.¹⁴¹

Moreover, attracting judicial attention to the public potential of the derivative action is strongly supported by the traditional raison d’être of the derivative action.¹⁴² Standing to bring a derivative action is conferred when it is necessary

¹³⁶ IH Chiu, above n 134, 338. This is because the investor protection objective, which could be pursued in a minority derivative action in court, may not be capable of being met through private bargain. It should be noted that in the US, where the contractarian approach is more widely accepted, modification of the minority derivative action by allowing derivative grievances to be arbitrated in lieu of a derivative action in court has become acceptable. See JA Sanborn, ‘The Rise of Shareholder Derivative Arbitration in the Public Corporation: In Re Salomon Inc Shareholder Derivative Litigation’ (1996) 31 Wake Forest Law Review 337. See also AJ Sockol, ‘A Natural Evolution: Compulsory Arbitration of Shareholder Derivative Suits in Publicly Traded Corporations’ (2003) 77 Tulane Law Review 1095 (arguing that shareholder arbitration should become the norm for derivative actions).
¹³⁷ Under 5.2.3.
¹³⁹ ibid. For judicial recognition (in Canada) of the public role of management, and the corresponding need for strict standards of conduct, see Canadian Aero Service Ltd v O’Malley [1973] 40 DLR 3d 371, 374 per Laskin J.
¹⁴⁰ In the sense that their existence can only be construed on the facts of each case.
¹⁴² For example, the fact that a member may bring a derivative action in relation to wrongs which were done to the company before he became a member (Seaton v Grant (1867) LR 2 Ch App 459) illustrates that compensation cannot be the sole rationale (‘true injury’ is not required).
to avoid the injustice of a serious wrong to the company going unredressed.¹⁴³ Such an approach invites early consideration of the public character of derivative actions.¹⁴⁴ Moreover, once private disputes are brought into a public courtroom, a limited public interest must be recognized as attaching to the process by which they are resolved. This public interest does not require that every cause of action be litigated to the hilt at whatever cost to the company and its shareholders, but it does necessitate that courts conduct their business in a seemly fashion. If a court is told that bribery is a profitable (albeit illegal) means of doing business and that the company has no plans to discontinue these practices, that court is morally compromised if it thereupon dismisses the action.¹⁴⁵

### 2.4.2.2 Tying derivative actions to a failed objective

Social scientists have long stressed the importance of ‘framing’ in evaluative decisions. The anchor point that is set forth has a significant impact on the judgment made about a proposition. The anchor not only fixes the point at which inquiry begins, but it is also frequently the standard for judging the merits of an idea, argument, or social institution.¹⁴⁶ In this respect, the public perception of the derivative action and its social meaning has been affected by such framing. Complementing the courts’ cynical view of derivative actions¹⁴⁷ chiefly as private matters, the debate surrounding derivative actions in the UK continues to judge their social value in terms of how often they are pursued¹⁴⁸ and how they compare to the alternatives.¹⁴⁹ By finding (unsurprisingly), as they do, that derivative actions fail in their mission, the studies support a negative view of their social value.

Against this benchmark, the derivative action has fared badly in terms of the public perception of its theoretical value. Tying the measure of the derivative action’s social value to this benchmark will most certainly condemn it to failure. Certainly this is the case with derivative actions in English law. The prevailing

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¹⁴³ Smith v Croft (No 2) [1988] Ch 114, 185.
¹⁴⁴ See also Lord Wedderburn ‘The Social Responsibility of Companies’ (1985) 15 Melbourne University Law Review 4, 24: ‘[fiduciary duty] is imposed in private law, but with a public function. It is a vehicle of a social purpose’ (emphasis in original). See generally JE Parkinson, above n 25, Ch 7.
¹⁴⁷ Perhaps best illustrated by Templeman LJ in Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) where the derivative action procedure was referred to as ‘lamentable litigation’ with its ‘horrendous costs’ and that the company in that case might have felt that ‘it might be killed by kindness’ ([1982] 1 Ch 204, 220–2).
¹⁴⁸ In which case, they fare rather badly as these actions are rarity. See, for example, E Ferran ‘Company Law Reform in the UK’ (2001) 5 Singapore Journal of International and Comparative Law 516.
¹⁴⁹ A recurring theme in the literature is that the unfair prejudice is, and is likely to remain, a far more attractive and convenient remedy for shareholders. Examples abound. For a recent explication of this view, see, for example, J Payne ‘Shareholders’ Remedies Reassessed’ (2004) 67 MLR 500, 501–2; J Payne and DD Prentice ‘The Corporate Opportunity Doctrine’ (2004) 120 LQR 198, 202.
view is one that lends itself to measures of success and failure and frequency of proceeding as opposed to a theoretical or an abstract benefit (ie deterrence). The preoccupation with success or failure is understandable since this is measurable but, as we saw above, deterrence is not. Derivative actions are thus tied to a measurement, ie the number of actions brought per year, that most surely is an indication of their failure, not their success. However, as will be seen, it is arguable that the success of any replacement for the current obsolete procedure would best be judged not by the quantity of the case law generated under the new procedure, but by whether the rules governing the circumstances in which such an action may be brought are made more comprehensible and accessible so that, in exceptional circumstances, the commencement of a derivative action is regarded as a remedy worth pursuing instead of being ruled out at an early stage of a dispute as being far too difficult even to contemplate.¹⁵⁰

2.4.3 Applying the right inhibitions

The social meaning of an act can be shaped by the inhibitions imposed around it. By inhibiting certain behaviour, the occurrence of which would otherwise create or reinforce a disfavoured social meaning, we shape our perception of the act itself.¹⁵¹ Similarly, some procedural requirements provide important inhibitions that should contribute positively to the view of derivative actions being seen as important social mechanisms.

The most important inhibition that can be used to nurture positive deterrent effects flowing from derivative actions are pre-trial procedures that lead to the dismissal of baseless suits.¹⁵² Consider CPR r 19.9(3) (or CA 2006, s 261(1) for that matter), for example. Both expressly require the court’s approval for the continuance of a derivative action.¹⁵³ The court’s early involvement in the facts supporting the derivative action complaint provides an important pre-trial screening mechanism by which the action’s merits may be assessed.¹⁵⁴ Screening

¹⁵⁰ S Deakin E Ferran and R Nolan ‘Shareholders’ Rights and Remedies: An Overview’ [1997] 2 CFILR 162, 165. See Ch 5 below under 5.4.2.4.
¹⁵¹ Cox ‘The Social Meaning’, above n 43, 20; L Lessig, above n 121, 1013 and 1032. Professor Lessig illustrates this point by stating that segregated neighborhoods would be reinforced if real estate brokers were permitted to disclose the racial composition of a neighborhood. In the US, the Fair Housing Act bars such disclosure and thus reduces the likelihood that the selection of a new home will be made on the basis of racial considerations.
¹⁵³ It has been held that the mandatory requirement for permission under CPR r 19.9 cannot be dismissed as a mere technicality and reflects the real and important principles that the Court of Appeal reaffirmed in Barrett v Duckett [1995] 1 BCLC 73 and underlines the need for the court to retain control over all the stages of a derivative action. See Portfolios of Distinction Ltd v Laird[2004] EWHC 2071 (discussed in A Reisberg ‘Judicial Control of Derivative Actions’ (2005) 8 ICCLR 335); Jafari-Fini v Skillglass Ltd [2005] EWCA Civ 356; Harley Street Capital Ltd v Tchigirinsky [2006] BCC 209.
¹⁵⁴ In its contemporary formulation, however, the courts’ discretion fails as an efficient screening mechanism, as is illustrated in Ch 3 below under 3.4.2.
the merits of the action provides an important bulwark against the continuation of strike suits past the leave to proceed. The pleading requirement has a positive winnowing effect so that derivative actions that meet these pre-trial demands enjoy greater merit than if these requirements did not exist. The approval of the court acknowledges that the company was right to have initiated the action in the first place. Secondly, and equally importantly, upon satisfying the court’s requirement, the derivative action can more easily be understood to reflect a public condemnation of the conduct that is the subject of the action. It is only through satisfying the court’s requirements that the claimant earns the right to bring the action (a procedure which otherwise does not exist in ordinary civil cases). To the extent that, following the pre-trial procedures, meritorious cases tend to survive, the continued prosecution of a suit can be expected to have a greater public value than if there were no pre-trial procedures. This is because on average there would be a higher likelihood that a derivative action complaint addressed actual misconduct. It thus appears that socially desirable inhibitions may exist that contribute to derivative actions serving as a valuable deterrent to misbehaviour by corporate managers.

2.4.4 Procedural requirements and settlements

The fourth technique for shaping social meaning is through rituals that induce actions that are likely either to support or to weaken a particular social meaning. The most visible and important rituals for the derivative action are the procedural requirements that accompany the initiation and settlement of the action.

In addition to the need to be granted with the court’s permission to continue a derivative action, which confers some sort of a public status on the action’s claimant, strength in the settlement process enables the derivative action to secure its position as a mechanism for vindicating public norms. As seen earlier, because of his small stake in the company, the complaining shareholder has very little incentive to consider the effect of the action on the company. Thus derivative actions create a risk of strategic behaviour by minorities. They open the possibility for ‘gold-digging’ claims against the company which are settled on terms advantageous to the claimant shareholder and the defendants but which do not reflect the value of the company’s rights or are not in the interests of the company. This is the reason, for example, why an order for an indemnity in respect to costs that may be awarded to a shareholder to help him maintain a derivative action also requires

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156 See further A Reisberg ‘Judicial Control of Derivative Actions’ (2005) 8 ICCLR 335.
157 One example is singing the national anthem at sporting events. Cox ‘The Social Meaning’, above n 43, 28; L Lessig, above n 122, 1013–14, 1032–4.
the claimant to refer back to the court for approval of any offer of settlement of the action.¹⁵⁹ This, in turn, may reduce the possibilities for ‘gold-digging’ claims against the company which are settled on terms advantageous to the claimant shareholder and the defendants but which do not reflect the value of the company’s right or are not in the interests of the company. This procedure is analogous to that in the US system for class and derivative actions, which does not otherwise exist in the procedure under English law.¹⁶⁰ Settlement is thus an important ritual in the life and image of the derivative action. If properly understood, it is a ritual that should raise the public image of the action.¹⁶¹

2.5 Conclusion

The foregoing discussion suggests that there is a role for derivative actions in reducing agency costs. Generally speaking, the derivative action balances two competing sets of agency costs: litigation costs and management costs. It generates litigation costs, for example, when it consumes an undue amount of management time, a time that might be more profitably be used seeking appropriate opportunities for investments. At the same time, it can minimize management costs when it (1) enforces directors’ duties (the traditional view); (2) deters management wrongdoing by aligning the interests of managers through liability rules (arguably the primary benefit); (3) compensates for damages suffered by the company in money’s worth (a controversial point); and (4) clarifies the scope of permissible conduct through judicial decisions (a somewhat limited role in the UK).

Crucial to the deterrence rationale is the fact that the deterrent value of derivative action is tied to the public’s perception of the value of such litigation. The higher the public esteem of the derivative action, the greater will be its deterrent value. As it currently stands, the ambiguity of the purpose of the action and tying derivative actions to a failed objective weaken the social influence of the derivative action in English law. On the other hand, the above review found that the procedural requirements that fostered court screening of the action’s merits as well as the control of settlements are two important features of the derivative action which should, in theory, enhance its social meaning. In Chapters 5 and 6, we shall consider strategies that can be pursued to reverse the negative effects of those forces that weaken the social meaning of derivative actions so that the action is more likely to be viewed as an instrument that affirms desirable norms in the corporate setting.

Ultimately, the question that this chapter raises is whether the possible benefits of the derivative action are outweighed by its costs. Before it is possible to answer

¹⁵⁹ For example under CPR r 19.9(3).
¹⁶¹ See A Reisberg, above n 155.
this, an additional dimension must be explored first. Policy considerations are of prime importance in this respect. If it were true, for example, that a shareholder is rarely allowed to sue on behalf the company, as seems to be the underlying policy of English courts, the conclusion might follow that the action had little deterrent effect and could rarely achieve compensatory or other purposes. In such an event, regardless of its costs, the benefits of litigation would seem too minimal to justify substantial reliance on it. Before the theoretical objectives identified here may play any role in the UK, it needs to be examined then whether these issues can be dealt with adequately. The next chapter begins such an inquiry.